Introductory letter
to the Annual Report of the Banque de France

Submitted to:
the President of the French Republic,
the President of the Senate and
the President of the National Assembly

by:
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2015

BANQUE DE FRANCE

EUROSYSTÈME

France in 2016 has more going for it than it thinks. It is the second biggest economic power in the euro area, with the largest geographical area. It has one of the fastest population growth rates in Europe, with the highest proportion of young people.[1] Its hourly labour productivity is among the best in the world, on a par with that of the United States and Germany. It is the European country with the largest number of firms in the top 100 most innovative companies in the world[2] and it is one of the most dynamic in terms of business creation; its largest firms are strong competitors at the global level. Moreover, France's economy is now returning to a more sustained growth thanks to the rebound in consumption and investment.

However, the France of 2016 still clearly harbours doubts due to its persistent economic and social weaknesses. Despite the recent decrease in unemployment, this scourge continues to affect over 3.5 million people in metropolitan France: 24% of the under-25 labour force is unemployed. Our growth naturally remains below that of the past cycles, but also below the euro area average. Government debt reached 96% of GDP in 2015, despite the better-than-expected deficit.

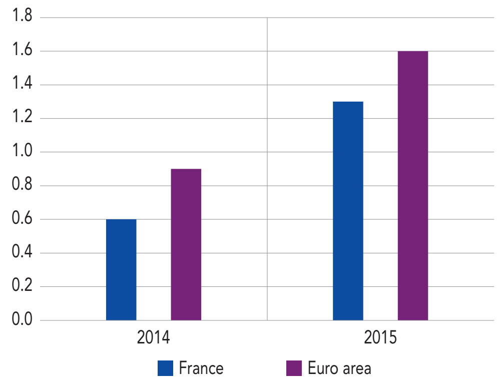
Significant progress has been made. Nonetheless, there is still much to be achieved. The current improvement in economic conditions is insufficient, and we must build on it in order to boost potential growth. Not only is it vital to step up reforms but it is also possible. Our past experience, as well as that of our European neighbours, shows us the path of a sustained collective effort in order to return to a stronger, job-creating growth.

1. A partial recovery, insufficiently underpinned by confidence and reforms

1.1 A relatively favourable economic environment in the euro area, despite uncertainties

In 2015, economic activity strengthened in the euro area: real GDP grew by 1.6%, after 0.9% in 2014 (Chart 1) and has returned, for the first time since the crisis, to the level reached in 2008.

Chart 1 GDP growth rate
(average annual change, %)



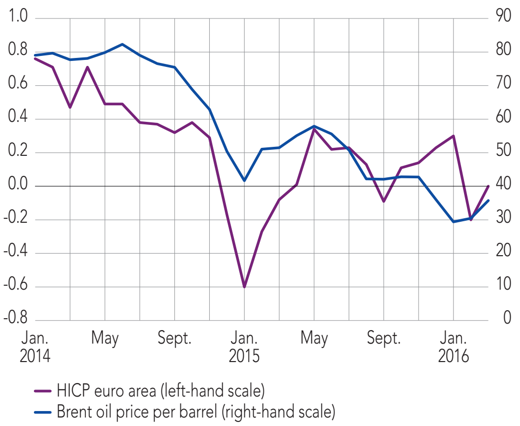
Sources: Insee, Eurostat.

Admittedly, the start of 2016 was marked by global economic uncertainties: excessive financial market volatility; the collapse of commodity prices, including oil – the US dollar price of a barrel of oil plunged by over 60% between June 2014 and December 2015,

1 With almost 21 million people under 25 years old.
2 According to the ranking compiled by Thomson Reuters.

Chart 2 Euro area inflation rate and price of oil per barrel

(year-on-year, %, price in euro per barrel)



Sources: Bloomberg, Datastream.

causing inflation to fall to close to zero (Chart 2); and an economic slowdown in certain emerging countries, including China. Nevertheless, the European economic recovery – corroborated by 0.5% growth in the first quarter of 2016 – benefited from the positive impact of low oil prices on household purchasing power. Furthermore, the weaker euro in 2014 led to an increase in market share, offsetting the sluggish global demand.

1.2 Monetary policy plays an active role

Against this backdrop, the Eurosystem – the ECB and the 19 national central banks – acted with determination to fight too-low inflation, in accordance with its mandate. Since June 2014, it has extended on several occasions its non-standard monetary policy. However, at close to zero year-on-year in Q1 2016, euro area inflation remains too low. This very specific combination of factors – ample liquidity, historically low interest rates or even negative in some cases, but with no inflation – is raising, beyond the contention in Germany, questions about monetary policy: is it pursuing the right objective? Is it effective?

The Eurosystem remains committed to its objective of maintaining inflation at a level below but close to 2% over the medium term. A slightly positive inflation is indeed considered to be the appropriate level for price stability: it provides enough leeway to safeguard against deflationary dangers; it facilitates relative price and wage adjustments, and allows players to deleverage. Indeed, all the other major advanced economies – the United States, Japan, and the United Kingdom – also use a 2% inflation target. This encourages companies and households to anchor their inflation expectations beyond short-term uncertainties. If, conversely, monetary policy did not respond to inflation expectations that were persistently too low, it would have an adverse impact on growth and financial stability in the longer term; a stability to which even the most outspoken critics of the current monetary policy are rightly attached.

So, are the instruments used effective? Economically speaking, the low interest rates are the logical counterpart of the current situation in which savings largely exceed investment. In practice, the measures taken by the Eurosystem have been beneficial in two ways: on the one hand, the cost of lending has fallen thanks to the decline in interest rates; and on the other hand, the volume of lending to firms and households has risen. For instance, lending to non-financial corporations is now growing (growth of 1.1% year-on-year in March 2016, and of up to 4.3% for France), whereas it was decreasing in mid-2014 in the euro area (down 2.5% in June 2014). This improvement in financial conditions contributed an additional 0.3 percentage point to growth in France in 2015 according to Banque de France estimates, and even 0.4 percentage point according to Insee.[3] Between 2016 and 2018, monetary policy should add almost 0.5 percentage point of inflation per year on average.

Moreover, the Eurosystem remains vigilant as to any possible side-effects of monetary policy. French banks are far more resilient than in 2007, with a solvency ratio that has doubled, from 6% to 12%, thanks to the new Basel III regulations. France's Haut Conseil de stabilité financière (HCSF – High Council for Financial Stability) closely monitors the financial cycle and ensures that bubbles are not forming with regard to certain key variables, including equity prices, property prices and credit volumes. It has a broad range of macroprudential instruments that it stands ready to implement if necessary, a process it initiated in April for the Île-de-France office property sector, for example, with the publication of a warning report.

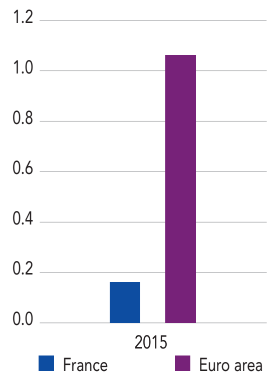
Monetary policy is effective, but it cannot be the only game in town: the other economic policy levers must also play their part (see below).

1.3 Despite the progress, France's performance remains relatively disappointing

Against the backdrop of a more favourable economic environment in 2015, progress was made on five key indicators of the health of the French economy: growth, employment, productive investment, public finances and the trade balance. Economic growth accelerated from 0.6% in 2014 to 1.3%[4] in 2015. It was underpinned by the rise in household consumption (1.5%) and by the strength of corporate investment (2.8%).[5] The business climate improved to reach a four-year high in October 2015: since then, it has remained above its long-term average. In 2016, following a 0.5%-increase in the first quarter, growth should exceed the level observed in 2015. For all that, France's recovery is more patchwork than that of the euro area as a whole, which is itself too partial.

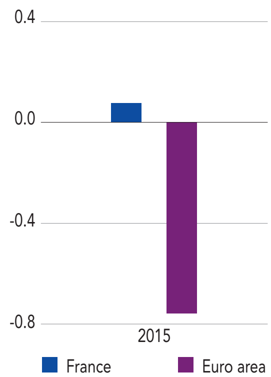
• This positive French **growth**, which was nevertheless 0.3 percentage point lower than that of the euro area, is reflected in a larger difference in **employment growth**: up 0.2% in France, compared with 1.1% in the euro area as a whole (Chart 3a); consequently unemployment did not fall in 2015, making France an exception (Chart 3b).

Chart 3a Growth in market sector employment
(average annual, %)



Source: Eurostat.

Chart 3b Unemployment rate
(percentage point change)



Source: Eurostat.

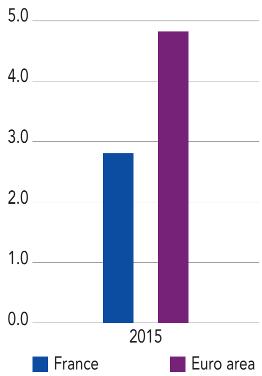
3 Heam (J.-C.), Marc (B.), Lee (R.) and Pak (M.), "*L'assouplissement quantitatif de la BCE a fait baisser les taux d'intérêt et contribue à la reprise de la zone euro*", Insee, *Note de conjoncture*, Dossiers, December 2015.

4 and 5 According to the annual national accounts (not working-day adjusted) published by Insee on 17 May 2016. All other figures and charts in this letter are based on quarterly accounts.

• **Productive investment** in France firmed, but slightly less than in the euro area (Chart 4). As regards **public finances**, the French deficit thankfully fell significantly, from 4.0% to 3.5% of GDP, but remains higher than the euro area average; within this area, government debt dropped by 1.3 percentage points of GDP over the year whereas it continued to increase slightly in France (Charts 5a and 5b). It is essential, for the credibility of our country in Europe, to rigorously pursue fiscal consolidation, and to bring the general government deficit well below 3% of GDP by 2017.

Chart 4 Growth in productive investment[a] for the economy as a whole in 2015

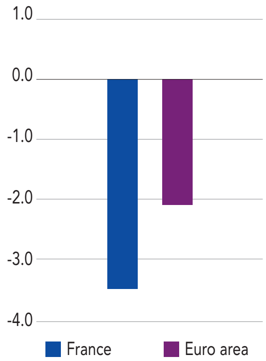
(average annual change, %)



a) Ratio of GFCF in machinery and equipment and intellectual property rights (excluding construction) to value added, in value terms.
Source: Eurostat.

Chart 5a Government deficit in 2015

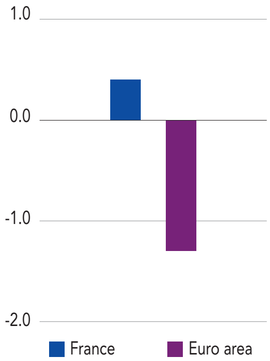
(% of GDP)



Source: Eurostat.

Chart 5b Change in public debt between 2014 and 2015

(in GDP percentage points)



Source: Eurostat.

• Lastly, in 2015, France saw an improvement in its current account balance, which practically returned to equilibrium (–4.3 billion[6] against –19.7 billion in 2014), for the first time since 2006, thanks largely to the fall in the energy bill.

For too many years, France has underperformed, even though **demand-side policies** are in place: monetary policy is accommodative; the fiscal stance has returned to neutral in the euro area as the structural balance has stopped improving. However, **supply-side policies** are also needed to achieve a sustained increase in potential growth, including notably structural reforms, whose effects are longer lasting even though they are slower to materialise. In France, there often tends to be an over-simplistic view that sets demand and supply policies at odds, whereas they are in reality complementary. In order to act on growth now, we need to reconcile them, as the IMF, among others, has stressed.[7]

And to attain sustainable growth in France, two additional levers are necessary: confidence and reforms. **Confidence** is the vital and oft-overlooked microeconomic lever. Confidence alone, and first and

6 Preliminary data, pending publication in June by the Banque de France of the 2015 balance of payments annual report.

7 IMF, "Too slow for too long", *World economic outlook*, April 2016.

foremost that of entrepreneurs, prompts players to invest and commit to the future. There are two prerequisites for anchoring confidence over the long run in our country: on the one hand, simple and stable rules that provide economic agents with a clear, predictable and reliable decision-making framework; this includes a strong "simplification shock". And, on the other hand, confidence requires a true dialogue between all company stakeholders – employers, unions and public authorities – in order to find mutually beneficial solutions. Finally, to shore up confidence, structural reforms must be resolutely pursued.

1.4 A long-standing consensus on the necessary reforms

The realisation that we need to intensify structural reforms in France is hardly new. The letters by my predecessors, the IMF, the OECD, the European Commission, the Cour des comptes and France Stratégie have all made similar recommendations. Rather than repeating them in detail, let us summarise them, focusing on four key areas: business, employment, education and government.

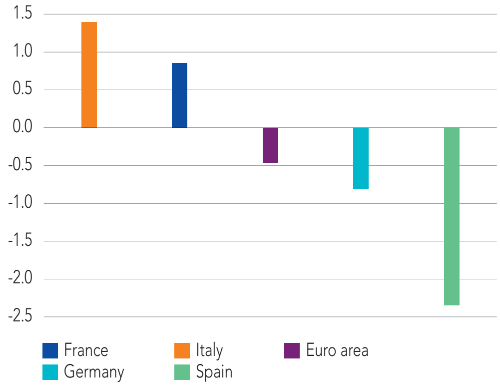
The recommendations regarding **business** concern firstly the reduction of product market rigidities: the existence of entry barriers and the lack of competition on certain markets – in particular those least exposed to international competition – stifle innovation. Second, research and development and corporate productive investment are the key determinants of long-term growth and productivity. Not only are public support measures required, but also easier access to equity financing, which is better suited to innovative investments. In the United States, the net equity of non-financial corporations amounted to 121% of GDP at end-2015, compared with just 65% in France.

As regards **employment**, a number of obstacles have also been clearly identified in France: high labour costs for employers, in particular among low wage earners due notably to wage bargaining and minimum wage revaluation mechanisms. To achieve the legitimate aim of supporting low wages, public measures, such as the active solidarity benefit (RSA) and the employment allowance or reductions in social security contributions, should be more widely used; fortunately, such measures have recently been stepped up. Rigidities make it harder for firms to adapt to the business climate and discourage hiring. The labour market is too polarised between workers enjoying permanent contracts that afford a high degree of protection, and the unemployed who only have access to temporary contracts. Young people, in particular, are therefore the first to be excluded from the labour market in France. Social dialogue – more advanced among many of our neighbours, especially Germany – must be overhauled and decentralised to the company level, i.e. as close as possible to the economic and human reality. It is necessary to better make up for the delay in implementing a French-style "flexicurity" model, combining flexibility for companies and secure career paths for employees. The new labour law currently being discussed provides for welcome progress in this respect.

Education is the third regularly acknowledged priority. France suffers on the one hand from unequal initial training: the scores of the PISA assessment show that the correlation between the socio-economic backgrounds of pupils and their school performance is more marked than in most of the other OECD countries. And, on the other hand, it is affected by the fact that the training of the young and unemployed is not sufficiently tailored to business needs. For instance, there is a nagging paradox between the persistently high level of unemployment and the recruitment difficulties that firms face.[8] Indeed, vocational training remains poorly targeted and insufficiently cost-effective. Apprenticeships above all remain massively underdeveloped compared to northern European countries. France has three times fewer apprentices than Germany, and three times more unemployed young people.

Chart 6 **Change in government spending between 2011 and 2015**

(in GDP percentage points)



Source: Eurostat.

Lastly, the reform of **government** – and of the public sector in general – is also indispensable. Modern public administrations that provide high-quality public services, at a lower cost, are essential to the competitiveness of the economy. Local authorities and social security funds must also reform. In this area, it is vital to keep government expenditure in check. Here, France is an exception in that the level of government spending (56.8% of GDP) remains much higher than the euro area average (48.6%). Moreover, fiscal consolidation since 2011 has been less driven by spending cuts than increases in taxes and social security contributions (Chart 6). Sectoral spending benchmarks such as those initiated by France Stratégie provide valuable information that can be used to make real choices, rather than a succession of general cuts.

The revenue lever has indeed reached its limits. Today there is a window of opportunity to reform taxation while keeping overall contributions constant: increase tax on fossil fuels – given their very low price – with a favourable impact on the environment, and reduce labour tax thus stimulating activity. Such a reform would make even more sense if it were conducted in a coordinated manner at the European or international level.

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Admittedly, many reforms have been carried out in France over the past few years, including pension reforms, and those associated with the Responsibility and Solidarity Pact (PRS) and the Competitiveness and Employment Tax Credit (CICE). A number of studies conducted by the Banque de France nevertheless show the interest of more ambitious reforms: for

8 In France, almost three-quarters of companies (weighted by their number of employees) consider the lack of availability of skilled labour as an obstacle to hiring according to the survey Wage Dynamics Network - Eurosystem.

example, the adoption of "best practices" in terms of liberalising product markets and adapting the labour market could generate productivity gains in France of between 3% and 5% in the long term.[9] The example of our European neighbours shows this even more clearly: for a lasting result, France must intensify its reforms and, above all, stay the course.

2. For a sustained collective effort

In France, we are aware of the need to change. But we doubt our ability to do so. And we are schizophrenic about our desire to change: we want reform, but first for others.

This is true between economic players – the public and private sectors blame each other for our failures – as well as within social categories and professional bodies. Year after year, we appear to consolidate our "preference for division" and our inability to implement a shared strategy. But, that said, a collective effort is both necessary and possible in France. To achieve this, we need to broaden our perspective. Chronologically: since we have already succeeded in the past. And geographically: since our European neighbours have succeeded more recently and are now reaping the rewards.

2.1 A chronological perspective

Beyond business cycles, our long economic history, over the past three decades, can be seen as a succession of two distinct periods: before and after the successful adoption of the euro. At the risk of over-simplifying this cut-off point around the year 2000, the analysis distinguishes between two 15-year periods, which in all events go beyond political divisions since they span electoral cycles.

Between 1985 and 2000, France made sustained efforts to shore up its competitiveness, in order notably to enter the euro in a good position. It then implemented, not without weaknesses but generally with steadfastness, an ambitious competitive disinflation strategy: deindexation of wages to prices, a stable exchange rate policy compared to its European partners,[10] a relative consolidation of public finances, the opening up of competition and the strengthening of our companies. Despite the economic shock associated with German reunification and the recession of 1993, this strategy bore fruit as of the second half of the 1990s, when we were already de facto in monetary union. France entered into a period of strong economic growth, reaching 2.7% per year on average between 1993 and 2000, and exceeding 3.5% per year at the end of this period, or almost one percentage point more than Germany in 2000; its current account surplus was solid and persistent (1.6% of GDP on average between1993 and 2000); and employment continued to grow at a reasonably strong pace, 1.5% per year over the same period and over 2.5 % per year at the end of the 1990s.

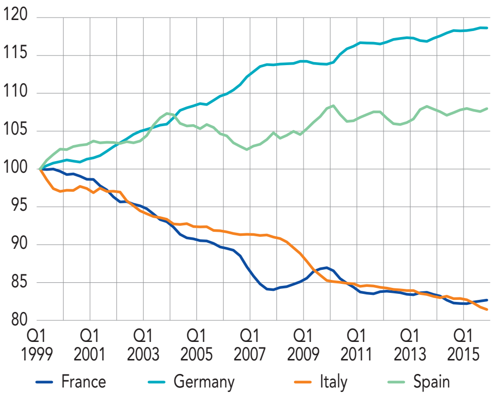
Conversely, **between 2000 and 2015**, the relative performance of France deteriorated. In the first part of the 2000s, once it had acquired the collective gain

9 Cette (G.), Lopez (J.) and Mairesse (J.), "Product and labor market regulations, production prices, wages and productivity", NBER, *Working Paper*, No. 20563, October 2014.

10 After a final adjustment in 1987.

of the euro, France, like many southern European countries, gave into the temptation of facility; then the 2008 crisis exacerbated its weaknesses. We are all fully aware of the advantages of the euro – and the great majority of French citizens are, rightly so, attached to it:[11] the currency is robust and inspires confidence; interest rates have come down sharply; economic life and travel within Europe have become much easier. But we have interpreted some of its economic consequences less well than other countries: we wrongly believed that, under the euro, we could let up on this competitiveness drive, but it is an ongoing imperative. France's cost-competitiveness has waned: between 2000 and 2008, unit labour costs rose by 17% in France compared with Germany – the reduction of working time was one of the factors behind this. Since 2008, however, unit labour costs have fallen by 6% in France compared with Germany, partly thanks to the CICE. However, only one-third of the deterioration of the previous years has been made up for.

Chart 7 Ratio of export values of goods and services to total euro area exports
(Q1 1999 = 100)



Sources: Insee, Eurostat, BCE, Banque de France calculations.

Therefore, between 2000 and 2015, France's market share in global trade in goods declined significantly compared to its main competitors and to the euro area. While it stood at over 5.5% at the end of the 1990s, it fell for a long period during the 2000s. In 2015, it came in at 3.1% against 8.8% for Germany. As a result, France's current account balance shifted into deficit after 2006. These developments naturally meant that France fell behind the best performing euro area countries in terms of growth and employment.

2.2 A geographical perspective

Our European neighbours also provide some encouraging examples. Many of them have succeeded in carrying out wide-reaching reforms that are fully compatible with our shared social model: for instance, Sweden in the 1990s, Germany in the 2000s, Spain since the start of the 2010s, and even, more recently, Italy – albeit only to a more partial extent. These examples of European reforms all have a number of things in common.

First, none of these countries waited for the good times before carrying out major reforms. In each case, the measures were implemented when the economy was in particularly bad shape: Sweden suffered a severe crisis at the start of the 1990s that led to a sharp drop in GDP and a surge in public debt, and sent unemployment soaring from 1.7% to 9.4% in four years; similarly, at the start of the 2000s, Germany was regarded as "the sick man of Europe"; and Spain was badly affected by the 2008 crisis.

11 At 67% in the most recent European Commission Eurobarometer survey – December 2015.

Chart 8a Aggregate GDP growth, 2014 and 2015

(%)

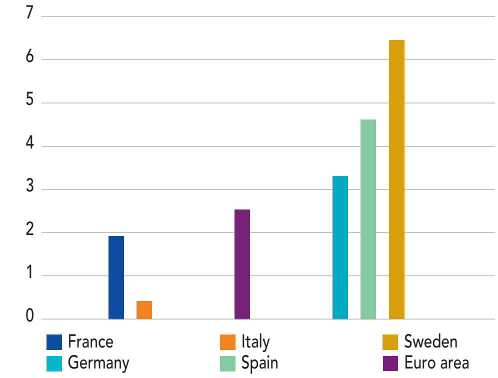
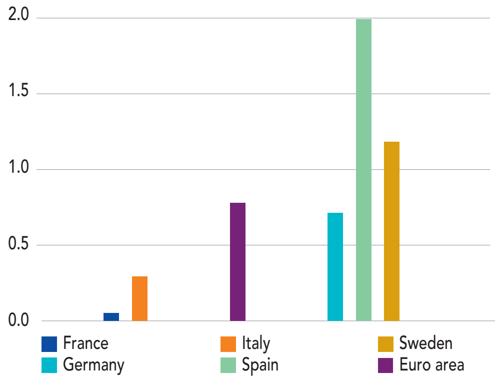


Chart 8b Aggregate growth in market sector employment, 2014 and 2015

(%)

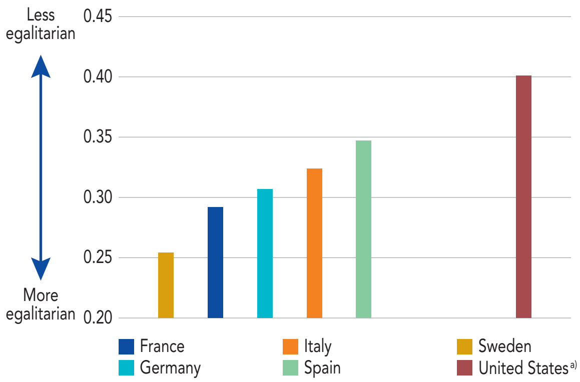


Sources: Insee, Eurostat.

Another distinguishing feature of these reforms was that, despite being implemented by very different political majorities, all were equally ambitious and steadfast in their focus. Choices were adapted depending on the country, but in each case progress was made in all four key areas described above: business, employment, education and government. In particular, all countries reformed their labour market. And these profound changes are still delivering results today: in recent years (2014-2015), GDP and employment have grown much faster in the "reforming" countries than in France and Italy (Charts 8a and 8b).

Lastly, the major reforms undertaken by our partners show that we do not inevitably have to choose between a more efficient economic model and a European social model our citizens rightly hold so dear. Those countries that have carried out reforms have much less inequality than the United States, thanks in large part to an efficient system of redistribution. In 2014, Sweden had one of the highest levels of equality in the world, and Germany remained at a level close to that of France. The differences between individual European countries are much smaller than the overall gap with respect to America (Chart 9).

Chart 9 Gini coefficient after tax and transfers, in 2014



a) For the United States, 2013 data.
Note: The Gini coefficient is a composite indicator of income inequality. The index ranges from 0 to 1; the higher the value, the larger the income gap.
Source: Eurostat, except the United States (OECD).

In France, showing that we can match this level of ambition is vital, not just for our country, but also to maintain our credibility in Europe so we can continue progressing towards **greater coordination of national fiscal and structural policies**. Together with an active monetary policy, this is essential for stimulating growth and employment. According to certain estimates, the current lack of coordination has cost the euro area between two and five percentage points of GDP growth since 2011. The abnormally large current account surplus – more than 3% of GDP – also clearly points to the need for a rebalancing within the euro area. However, greater coordination should not be seen as a substitute for much-needed reforms: national reforms **and** coordination within the euro area are both indispensable if we are to re-establish a relationship of trust between euro area countries. In order to be effective, full coordination also requires that we put in place a strong and legitimate institution: the decision for this will obviously fall to political leaders, but it could take the form of a euro area Finance Minister, presiding over the Eurogroup and tasked with formulating a "collective strategy" for the euro area, supervising its implementation at national level and steering crisis management tools.

In the shorter term, we need to extend the Juncker Plan and the Capital Markets Union in order to establish a genuine "Financing and Investment Union". This would involve creating synergies to better direct euro area household savings towards productive investment and equity, improving risk-pooling between countries, and thus ensuring more financing for the innovation and networks that the European economy needs.

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Seize our opportunity

Reforming our country in-depth is admittedly no easy task. France's current democratic cycle places it in a shorter-term context. However, the period ahead can and should be used as an opportunity to launch a new national debate, provide information on the options available, and choose a common strategy for the long term.

Carrying out in-depth reforms in our country will also take time, and will need to be an ongoing but sequenced process.[12] Knowing that there will be short-term costs can often blind us to the long-term benefits of reform. Our collective effort could take a longer-term perspective, with the aim of ultimately returning the country to full employment, and finally overcoming its biggest handicap – which is unemployment. The "J-curve" referred to in the case of structural reforms reflects the fact that it is sometimes necessary to experience a period of sustained efforts and a temporary worsening of conditions. This is where demand policies can prove useful, by helping to offset these transitional costs.

An accommodative monetary policy is already in place. And it shall remain in place, while maintaining a target of inflation of close to but just below 2% in the medium term, and keeping a close eye on financial stability. Within the Eurosystem, the Banque de France's role is to do everything it can to support our country, including by ensuring access to financing for businesses – notably SMEs – and households. It also needs to do more to shed light on the economic debate through the data and research it publishes.

12 France Stratégie, "*Quelle France dans dix ans ?*", *La stratégie*, June 2014, chap. 14.

After the severe crisis of 2008-2011, the first priority was to implement the necessary monetary and financial instruments in response – but more still needs to be done. As well as improving the current economic climate, we urgently need to extend our reforms, for the benefit of the young, the unemployed and French society as a whole.

We have risen to the challenge in the past; and, more recently, our European neighbours have also taken action successfully. It is up to us, as a country, to make the most of what France has to offer.

Paris, 17 May 2016

François Villeroy de Galhau